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Insuring Disaster: A briefing for policymakers

How the EU can improve the insurance framework 'Solvency II'

ShareAction»

About ShareAction

ShareAction is a non-profit working to build a global investment sector which is responsible for its impacts on people and planet. We mobilise investors to take action to improve labour standards, tackle the climate crisis, and address pressing global health issues, such as childhood obesity. Over the last 15 years, ShareAction has used its powerful toolkit of research, corporate campaigns, policy advocacy and public mobilisation to drive responsibility into the heart of mainstream investment. We want a future where all finance powers social progress.

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In this briefing we explain why the EU needs to show ambition on sustainability in the upcoming review of Solvency II, the legislation that sets out the rules for insurers. This will help to preserve the stability of the insurance industry and the financial sector as a whole, and will enable insurers to support the transition to a sustainable economy.

Introduction

"Code red for humanity" is how UN Secretary-General António Guterres described the conclusions by the Intergovernmental Panel on Climate Change (IPCC) about the state of the Earth's climate.[I] His words reflected not just academic predictions of the future, but also the reality of increasingly frequent and intense extreme weather events. Indeed, the list of deadly heatwaves and destructive floods in 2021 has been startling.

Insurers are directly impacted by these events; their losses to cover the damage caused by natural disasters were higher for the first half of 2021 than for any six month period since 2011.[II]

Insurers also have a vital role to play in helping communities and economies become low-carbon, climate-resilient and sustainable. European insurers are responsible for over €10.4 trillion of global assets under management.[III] In their roles as risk managers and investors, insurers can choose to direct financial flows towards companies that have a positive impact on the world and away from those industries with the most harmful effects on people and the planet.

In July 2021, leading insurers formed the UN-convened Net-Zero Insurance Alliance (NZIA), a net-zero network for the underwriting business. Industry initiatives such as this are a welcome development, but they alone will not be sufficient to enable a successful low-carbon transition. In particular, insurers will need a supportive regulatory landscape to accelerate progress across the entire industry.

The upcoming 2021 review of the Solvency II legislation for insurance firms offers the EU a vital opportunity to build this landscape by mandating that insurers consider sustainability risks in their investing and underwriting activities.[1]

This briefing seeks to:

- show that current EU insurance regulation does not adequately integrate sustainability considerations;
- highlight the important role that insurers play in supporting a transition to a sustainable economy;
- explain why incorporating environmental, social and governance (ESG) considerations contributes to the stability of the insurance industry;
- provide concrete recommendations on how Solvency II can better integrate sustainability in its governance, disclosure, and prudential (risk) provisions.

1 Underwriting is the act of accepting liability up to a specified amount in an insurance policy. To remain profitable, it implies that insurers evaluate the risk of losses attached to the insured goods (house, car, property) or individuals (drivers, persons). Depending on the probability of losses determined by the insurers, they will set a price – in other words, establish the insurance premium to be charged in exchange for taking on that risk

Ranking of EU Insurers

The EU is at the forefront of the global regulatory push for sustainability and its legislative requirements for investors have helped to drive sustainable finance up the international agenda.

ShareAction's recent ranking of 70 of the world's largest insurers' approaches to responsible investment and underwriting shows that European insurers perform far better than their Asian or US counterparts.[IV] The superior performance of European insurers is likely due to the strong regulatory signals on sustainable finance within Europe.

However, even within Europe, no insurance company received an AAA or AA rating. Out of the 14 European insurers rated and ranked by ShareAction, over half were rated C or below C. Four insurers received the worst rating, E. As our report shows, much work remains to be done to raise the standard of responsible investment and underwriting.

Ranking of EU insurers, based on ShareAction's Insuring Disaster report[V]

Country	Name of life and health insurer	Rating*	Description for rating band	Rank (Out of 39)
NL	Aegon	A	Strong management of risks and opportunities as well as impacts across multiple themes	2
FR	CNP Assurances	BBB	Management of risks and opportunities, building capacity in accounting for impacts across some themes	3

Country	Name of insurer with a property and casualty business	Rating*	Description for rating band	Rank (Out of 31)
FR	AXA	A	Strong management of risks and opportunities as well as impacts across multiple themes	1
GE	Allianz	A	Strong management of risks and opportunities as well as impacts across multiple themes	2
NL	NN Group	BB	Management of risks and opportunities, building capacity in accounting for impacts across some themes	4
IT	Generali	B	Management of risks and opportunities, building capacity in accounting for impacts across some themes	6
GE	Munich Re	CC	Building capacity in management of risks and opportunities across some themes	9
NL	Achmea**	CC	Building capacity in management of risks and opportunities across some themes	10
FR	Groupama Assurances Mutuelles	C	Building capacity in management of risks and opportunities across some themes	12
FR	AG2R la Mondiale	D	Little evidence to suggest adequate management of material risks and opportunities	14
GE	Talanx	E	Evidence suggests poor management of material risks and opportunities	18
BE	Ageas	E	Evidence suggests poor management of material risks and opportunities	19
GE	R+V Versicherung**	E	Evidence suggests poor management of material risks and opportunities	25
PO	Powszechny Zaklad Ubezpieczen (PZU)**	E	Evidence suggests poor management of material risks and opportunities	28

* Top grade possible: AAA

** Did not disclose – survey filled out based on publicly available data. The insurers in question were given the opportunity to review the information collected.

Why recent changes to include sustainability in the Solvency II Delegated Regulation fall short

The Solvency II Directive introduced a harmonised EU-wide insurance regulatory regime. Its objectives included ensuring policyholder[1] protection, effective risk management and financial stability.

The original Solvency II legislation (2009) and its delegated legislation (2015) have no explicit sustainability requirements.[VI,VII] However, recent changes (April 2021) to the Delegated Regulation do introduce obligations for insurers to consider and manage sustainability risks. This is in line with the European Green Deal communication which confirms "the need for long-term signals to direct financial and capital flows to green investment and to avoid stranded assets."[VIII,2]

The April 2021 changes to the Delegated Regulation, which will apply from August 2022, require that insurers integrate sustainability risks in key areas such as risk management, remuneration policy and the 'prudent person principle'.[3] The prudent person principle requires insurers to act as fiduciaries, putting the needs of the end investor central in their investment decisions. The modification therefore clarifies the integration of sustainability in fiduciary duties.

We welcome these changes to the Delegated Regulation as a means of reorienting the Solvency II framework towards sustainability. But these provisions fall short of setting a strong sustainability standard for the insurance industry because they remain principle-based and lack granularity.

The April 2021 changes to the Delegated Regulation give no explanation on how sustainability risks should be accounted for (for example when setting prudential requirements) and how to report on them. In order for the insurance industry to align with the EU's climate targets, Solvency II should reflect sustainability risks in more detail to ensure that these sustainability provisions are properly implemented and adhered to.

In its July 2021 Strategy for Financing the Transition to a Sustainable Economy, the European Commission announced that it would "consistently integrate sustainability risks in the prudential framework for insurers" as part of the Solvency II review.[IX] In the following sections, we offer recommendations for how this can be done and context for why those changes are necessary.

1 A policyholder refers to the person who owns and is covered under a given insurance policy.

2 The amendment to the Solvency II delegated act was presented as part of a bigger package aimed at clarifying institutional investors' and asset managers' duties in relation to sustainability considerations.

3 The prudent-person rule is a guideline for trustees and guardians tasked with administering assets on behalf of others to make financial decisions using the principles of common sense and reasonable risk to protect end investors, using the services of an investment advisor, from risky or questionable investments.

Recommendations to better integrate sustainability considerations in Solvency II

Recommendation 1: Require a double materiality approach

It is increasingly regarded as good practice for insurers to consider financially material environmental (including climate change), social and governance (ESG) risks in their decision making. But holding global warming to well under 1.5 degrees will require insurers to also consider the flipside: how their own business operations and investments are impacting society, climate change and the environment more broadly.

This ‘double materiality’ approach of considering both financially material sustainability risks (outside-in) and a company’s own sustainability impacts (inside-out) in financial decision-making processes is already included in other legislation with which actors in the insurance industry have to comply, such as the Sustainable Finance Disclosure Regulation (SFDR) and the newly proposed Corporate Sustainability Reporting Directive (CSRD). Both of these are focused only on disclosure of impact and do not require management or mitigation to limit negative impacts.

In order to avoid regulatory uncertainty and further damage to our planet and its people, now is the time to make sure all the rules that govern the insurance sector are fully aligned with each other, and with the aims of the Paris Agreement and the European Green Deal.

We recommend that the EU:

- incorporates the double materiality definition into the Solvency II framework. It is important to consider the impact an insurer can have on environmental, social and governance factors through its investment and underwriting decisions, in line with other key pieces of regulation contributing to the EU’s sustainable finance agenda, such as SFDR and CSRD;
- makes the connection between the ‘prudent person’ concept and ‘double materiality’ clearer, bearing in mind the centrality of the ‘prudent person’ concept in insurance regulation (see also recommendation 2). The definition of double materiality should feature in risk management and disclosure, and needs to apply to both investment and underwriting risks.

Recommendation 2: Clarify the new prudent person principle

The 'prudent person principle' is a fundamental element in Solvency II. It includes provisions on how undertakings should invest their assets,[X] namely that insurers should invest in a manner that ensures the profitability of their portfolios, and that they should "only invest in assets and instruments whose risks the undertaking concerned can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs." It is an important guiding principle that has not explicitly incorporated sustainability considerations before the 21 April modifications to the Delegated Regulation.

We welcome the changes to the Solvency II Delegated Regulation. These introduce a strategic modification to the principle by adding that "when identifying, measuring, monitoring, managing, controlling, reporting and assessing risks arising from investments, insurance and reinsurance undertakings **shall take into account sustainability risks**" (emphasis added). This modification confirms that sustainability considerations are part of insurers' fiduciary duties.[XI]

The integration of sustainability considerations in the prudent person principle can however be interpreted differently by Member States because of the high level nature of the principle and the lack of clarity about how sustainability risks should be taken into account.

We recommend that the EU:

- fully integrates the prudent person principle amendment to the Solvency II Delegated Regulation into the revised Solvency II Directive (level 1 legislation), given the requirements of the European Green Deal to incorporate sustainability into prudential regulation;
- provides guidance for the National Competent Authorities in Member States to check insurers' compliance with this provision. At a minimum, this should include disclosure on which sustainability risks and factors have been taken into consideration, and how this relates to clients' interests;
- makes explicit that the prudent person principle requires a double materiality approach.

Recommendation 3: Embed responsible stewardship practices

The review of Solvency II should give due consideration to the central role that investment stewardship[4] will play in directing capital into sustainable activities. It is important in helping to mitigate future risks – for example, by assisting in an orderly transition to net zero – and should be a major part of an insurer's risk management strategy. Perhaps more than other investors, insurers are at huge risk of losses caused by a disorderly transition which will not only impact their investments but also require them to pay out for climate change related disasters affecting their policyholders.

Our research shows that only a small minority of insurers and their managers have robust stewardship strategies in place to ensure their engagement with policyholders and investee companies is sufficiently ambitious. Insufficient attention is paid to responsible investment in the asset manager selection and monitoring process, and engagement with policyholders on the underwriting side is even less established. Transparency on stewardship activities is also poor, with some investors not publishing any information at all. [XII]

It is important that the Solvency II framework encourages stewardship. Insurers should much more actively engage with the companies in which they invest and use stewardship as a lever to encourage the growth of sustainable businesses in line with credible ESG commitments.

We recommend that the EU:

- requires stewardship policies, practices and reporting for investment and underwriting activities in Solvency II, and includes active engagement as part of the risk management system, covering environmental and human rights issues;
- requires investors to set out clear engagement objectives as part of the stewardship policy. An escalation strategy should be disclosed for dealing with unsuccessful engagements with investee companies and policyholders. This should include time-bound engagement objectives, a commitment to vote against the re-election of relevant board members or the remuneration policy, (co-)filing shareholder resolutions, pre-declaring the intention to vote in favour of shareholder resolutions, and sending an open letter to the company. Ultimately it could involve divestment;
- aligns these requirements with the engagement provisions in the SFDR that require investors to describe not only their engagement policies, as required under the Shareholder Rights Directive II, but also the outcomes of these interactions.

4 Stewardship in the context of sustainable finance refers to the means by which undertakings act to influence the strategy and business of the firms in which they are investing in order to progress towards sustainable economic activities. This principle is already recognised in the Shareholder Rights Directive II (Directive (EU) 2017/828 as regards the encouragement of long-term shareholder engagement)

Recommendation 4: Incorporate 'impact underwriting'

Insurers have a major role to play in steering capital flows towards green investment and avoiding stranded assets. They can do this not only through their investments but also through their underwriting strategies – the act of accepting liability up to a specified amount in an insurance policy.[5]

This is also recognized by the European Insurance and Occupational Pensions Authority (EIOPA), which defined the concept of 'impact underwriting' in a recent report: "(re)insurers, as risk managers and underwriters, can contribute to climate adaptation and mitigation by applying their data, expertise and risk assessment capacity to incentivise policyholders to mitigate insured risks via risk-based pricing and contractual terms, and consider in their underwriting strategy measures that contribute to climate change adaptation and/or mitigation." EIOPA stresses this needs to be done consistently with actuarial risk-based principles, which means that a proper risk-based assessment of the premium level should be performed.[XIII]

EIOPA suggests that insurers can implement impact underwriting through:

- integrating ESG considerations into insurers' underwriting strategies and decisions;
- developing new products that address risks stemming from climate change and promoting risk mitigating behavior;
- adjusting the design and pricing of insurance products using forward-looking pricing assumptions;
- providing risk-consulting services to clients for prevention purposes, especially for business clients;
- engaging with public authorities to promote risk awareness, risk assessment, disaster resilience and climate mitigation/adaptation strategies.[XIV]

ShareAction's recent ranking shows insurers' underwriting practices perform poorly in relation to ESG considerations.[XV] Only a few of the insurers considered climate change, biodiversity loss and human rights violations in their underwriting decisions, and no insurer had any restrictions on underwriting conventional oil and gas operations. The poor level of ESG integration at underwriting level was also recently recognized by Ekhosuehi Iyahen, Secretary-General of the Insurance Development Forum, who called for the industry to show "more ambition" in cutting the carbon impact of its underwriting.[XVI]

5 Underwriting is the act of accepting liability up to a specified amount in an insurance policy. To remain profitable, it implies that insurers evaluate the risk of losses attached to the insured goods (house, car, property) or individuals (drivers, persons). Depending on the probability of losses determined by the insurers, they will set a price – in other words, establish the insurance premium to be charged in exchange for taking on that risk.

The modified Delegated Regulation updates various important aspects of the insurers' risk management system. However, there remains little detail of how this will work in practice or any explicit policy to promote sustainable underwriting.

We recommend that the EU:

- requires that insurers develop sustainability-related underwriting policies, practices and reporting in line with EIOPA's proposal on impact underwriting in the Solvency II framework;
- requests EIOPA - pending the negotiations to agree on the revised Solvency II Directive - to develop guidelines for National Competent Authorities to issue letters to individual insurance companies. These letters should make clear what is expected of insurers with regards to sustainability considerations, thereby making up for the insufficient technical detail in the delegated act. This guidance could take inspiration from the International Association of Insurance Supervisors – the international standard-setting body for the supervision of the insurance sector – which developed recommendations for material risks associated with climate change for supervisors (see box).

The International Association of Insurance Supervisors' recommendations for material risks associated with climate change provide a useful set of operational guidelines that national supervisors can use to make clear to insurers what is expected of them in the risk management systems, and to ensure that the rules are consistently implemented across the Member States.[XV]

Supervisors should encourage insurers to enhance their underwriting assessment to consider:

- the track record and commitment of policyholders in managing climate-related risks;
- the ability and willingness of policyholders to mitigate the identified climate-related risks associated with the transaction;
- the duration of the policy;
- the need to impose underwriting conditions for certain types of products, requiring policyholders that are assessed to pose higher risks due to their climate impact to take steps to mitigate those risks. These conditions may include the development of a sustainable transition strategy and the adherence to relevant environmental certification standards.

Recommendation 5: Board oversight – 'tone from the top'

In our Insuring Disaster report, we found no evidence of board-level involvement in responsible investment and underwriting for half of the insurers surveyed, and that most boards have not received any relevant training or incentives.[XVIII]

The April 2021 changes to the Delegated Regulation do not include a specific provision with respect to the role of boards. It is assumed that boards are ultimately responsible for a sound system of governance, including the approval of risk management policies, the investment strategy and the key functions reporting.

The importance of setting the 'tone from the top' cannot be overstated in terms of the culture and strategic purpose of the company.

We recommend that the EU:

- clarifies the pivotal need for board-level oversight of the integration of the sustainability strategy, rather than a senior level management committee of a firm.
- requires boards to commit to working towards achieving net zero by 2050 or earlier, defining short- and medium-term targets, putting in place an effective strategy to meet those targets and publishing annual updates on their progress.

Recommendation 6: Strengthen reporting requirements

Current Solvency II reporting requirements do not include sustainability. At minimum, having the insurance industry report on climate-related sustainability issues, by following the disclosure recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD), allows for an understanding of plans and ambitions with regards to net zero strategies. The European insurance and reinsurance federation, Insurance Europe, recognises the added value of the TCFD recommendations for insurers:

"On the investment side, they can improve insurers' assessment of sustainability risks and help them to better plan their long-term investment strategies. On the underwriting side, the metrics proposed by the TCFD can help insurers' ability to understand and quantify their exposures to physical and transitional climate-related risks associated with their underwriting portfolios."[XIX]

We recommend that the EU:

- requires disclosure in line with the TCFD recommendations, which would reflect the G7 commitment to making TCFD mandatory across the economy.[XX] This should cover disclosure of insurers' transition strategies and targets, including the underlying methodologies they use for setting targets and measuring the progress of their investment and underwriting portfolios, based on a range of scenarios and considering adaptation and risk reduction activities.

These reporting requirements are aligned with and will facilitate compliance with SFDR and CSRD. They will also contribute to improved climate-related data across both the European and global markets. It is important that the EU follows Switzerland in adding double materiality to TCFD reporting.[XXI]

Recommendation 7: Align prudential requirements with the high risks posed by unsustainable activities

It is widely accepted that some of the activities and entities that insurance companies currently invest in and insure expose them to climate-related and transition risks.[6,XXII] The Commission's commitment (announced as part of the July 2021 Strategy for Financing the Transition to a Sustainable Economy) to investigate
"the risk differentials between environmentally and/or socially sustainable and other exposures in insurance" is a welcome recognition that varying levels of sustainability risks should be reflected in the Solvency II prudential framework.

However, sustainability risks are not taken into account in the current Solvency II capital requirements and wider prudential framework. The Solvency II prudential framework as it stands does not adequately reflect the actual risks associated with investing in or providing insurance policies to businesses involved in fossil fuel activities.

First, the capital charges for existing and new fossil fuel assets fail to account for the high risks associated with those assets. The capital charges for bond investments especially are too low, because they are partly determined by the credit rating of the company issuing the bond, and fossil fuel companies tend to have high credit ratings. The prudential treatment of fossil fuel exposures should be modified and aligned with the prudential treatment of other exposures currently considered highly risky.

Scientists, including the International Energy Agency, now agree that the full exploitation of new fossil fuel projects will not be compatible with a scenario where the EU meets the objectives of the Paris agreement. In light of this, it is especially important to subject equity and bond investments in new fossil fuel assets to higher capital charges that account for the high risks posed by new exploitation and production of fossil fuels.

Secondly, the prudential rules surrounding underwriting activities should also reflect sustainability risks. For instance, when estimating future cash-flows and losses related to insurance policies that cover policyholders engaged in fossil fuel activities, a more realistic and hence much higher probability of losses should be used. This is to account for the transition and climate risks that come with insuring entities and activities that rely on fossil fuel, especially new fossil fuel exploitation and production.

Thirdly, insurance firms that hold assets for a long period may be exposed to higher levels of climate-related and transition risks that are not currently reflected in the current treatment of assets. For instance, investments in fossil fuel assets are currently eligible for the 'matching adjustment' (MA), which sets out reduced capital charges (according to strict criteria) for long-term assets matched with long-term liabilities. Although the MA was introduced to account for the reduction in risk that comes from matching long-term assets and liabilities, it fails to incorporate long-term climate-related and transition risks, such as the risk that assets become stranded and lose value because of environmental and political developments.

6 A stark warning was given by the International Energy Agency (IEA) in its recent report on a transition to net zero, which calls for an immediate stop to all new oil and gas exploration projects https://www.iea.org/reports/net-zero-by-2050.

Similarly, the rules for calculating capital requirements in Solvency II do not incentivise long-term investments that are aligned with a low-carbon transition, as reported by many respondents in ShareAction's report, Insuring a Low Carbon Future.[XXIII] Indeed, the one-year time horizon of the Solvency Capital Requirement (SCR) calculation makes it difficult to incorporate longer-term climate-related risks.

Given the political commitment to the European Green Deal, the Commission should modify the MA and the SCR calculation to ensure they reflect long-term sustainability risks, including the specific risks associated with fossil fuel exploitation and production. This will incentivise insurers to contribute to investments that are not only long-term but also environmentally sustainable.

Altogether, the current Solvency II prudential framework provides insurers with extremely problematic incentives to invest in highly risky fossil fuel assets and underwrite fossil fuel-based entities and activities. This goes against the risk-based nature of Solvency II, and against the goals of the European Green Deal,[XXIV] which confirms the need for "long-term signals to direct financial and capital flows to green investment and to avoid stranded assets".

In order to protect financial stability and policyholders and contribute to the EU sustainable finance agenda's objective of encouraging sustainable investments and activities, the Solvency II prudential framework must duly incorporate sustainability risks.

We recommend that the EU:

- applies the prudential treatments for highly risky types of bond and equity investments to investments in fossil fuel assets. For bond and equity investments in new fossil fuel assets in particular, a capital charge of 100 percent should be applied to account for the enhanced risks that come with such investments;
- ensures that the prudential treatment of insurance policies that cover policyholders engaged in fossil fuel-related businesses also reflects the climate-related and transition risks – and the much higher probability of losses – that come with such underwriting activities;
- modifies the matching adjustment (MA) to reflect emerging climate change risks – investments in fossil fuel assets in particular should be ineligible for the MA;
- adjusts the Solvency Capital Requirement (SCR) calculation to put the ultimate time horizon[7,XXV] at the centre of the calculation, instead of the one-year SCR calculation. This would promote better measurement of and capitalisation against climate change risks, given the time horizon relevant to these risks;
- seriously considers whether all the above recommendations should also be applied to investment and underwriting activities related to greenhouse gas (GhG)-intensive industries and broader principal adverse sustainability impacts.[XXVI]

7 The ultimate measure captures the adverse development until all liabilities have been paid. The ultimate SCR considers all risks attaching to the proposed year of account and excludes exposures relating to underwriting years beyond the proposed year of account.

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